



UNINTENDED CONSEQUENCES:

How the efficiency agenda erodes local public services
and a new public benefit model to restore them

BRIEFING

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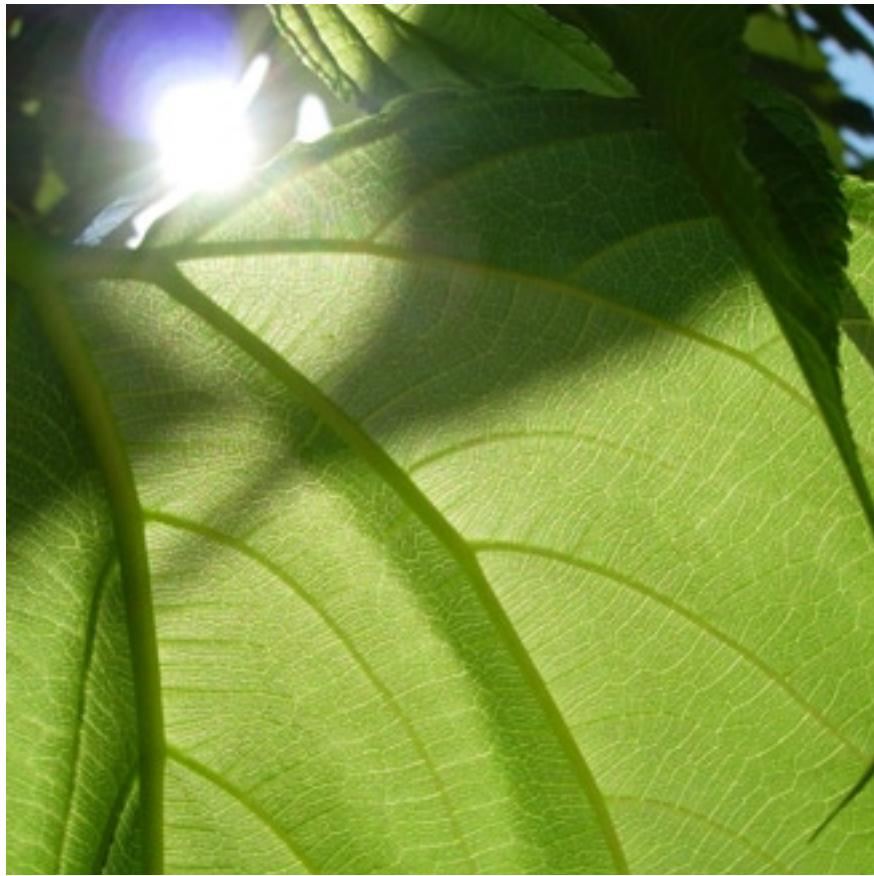


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nef (the new economics foundation) is a registered charity founded in 1986 by the leaders of The Other Economic Summit (TOES), which forced issues such as international debt onto the agenda of the G8 summit meetings. It has taken a lead in helping establish new coalitions and organisations such as the Jubilee 2000 debt campaign; the Ethical Trading Initiative; the UK Social Investment Forum; and new ways to measure social and economic well-being.



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Executive summary

The Government's efficiency drive is undermining the pursuit of effective local public services. The theory that underpins the drive for ever-greater efficiency is based on four assumptions or 'myths' about how to create efficient public services.

The implications of basing policy on these myths are stark. Remarkably, guidance accompanying the Gershon efficiency review from the Office of Government Commerce (OGC) explicitly states that benefits to the wider community should *not* be considered as efficiency gains: '*We do not recommend that departments adopt [either] approach, since savings do not accrue to the public purse.*' Wider benefits to the community, be they social or environmental, are not considered in the current model, which only recognises cost and the achievement of narrowly defined targets. A radical rethink is needed, based on a new *public benefit* model.

The four myths that underpin the current efficiency drive are:

- 1. Government intervention is justified only where there is market failure.** This fails to take account of what most people value in the public sphere and sets up a market model rather than one that, like all government activities, is affected by concerns of equity and social good.
- 2. Public services are best delivered through market-style competition and mimicking private sector incentives.** This denies and undermines the public sector ethos, and encourages a focus on reducing short-term costs.
- 3. Efficiency gains should be identified and imposed from the centre.** When added to the market model, this greatly increases the focus on reducing short-term costs at the expense of the wider public benefit.
- 4. The 'value for money' model ensures that efficiency and effectiveness are both pursued.** The easily measured financial indicators of efficiency are dominating the harder-to-measure indicators of effectiveness – particularly those of wider social and environmental benefits that are essential to good local services.

The result is a model which:

- Squeezes services to the most vulnerable and systematically neglects social and environmental impacts.
- Contradicts the Government's own policy to support and build strong local communities and economies, as community benefits are expressly ruled out from being included as Gershon efficiency gains.
- Contributes to a polarisation of the third sector, with the emergence of more, larger players at the expense of

smaller organisations (which are often community based and serve the most marginalised groups).

- Undermines trust between commissioners and providers of services and between providers through the competition and contestability model, and potentially destabilises longer-term care for the most vulnerable people.
- Actually raises transaction costs and increases the bureaucratic burden on both commissioners and providers of services.

nef (the new economics foundation) proposes a change of direction. Rather than the *market* model of public service provision that we have, or the *welfare statist* model that preceded it, we argue that the time has come to implement a *Public Benefit* model. In this framework the effectiveness of outcomes is assessed in terms of their benefit to users and the community; and service providers are encouraged to cooperate and innovate to maximise these benefits, rather than simply minimise costs. The result would be a model which:

- Creates a 'race to the top' by encouraging innovation and the maximisation of the social and environmental benefits that result from public service provision, both to those directly affected and to the wider public.
- Places people at centre stage with public services co-produced by commissioners, providers and service users, and with the latter seen as 'assets' in producing positive outcomes.
- Provides public sector actors with a more appropriate measure of efficiency when making purchasing decisions, which takes account of the vital role played by small voluntary and community organisations in local areas.
- Takes a 'social return on investment' (SROI) line, which builds the 'triple bottom line' approach into public service contracts, incentivising providers to maximise their wider impacts wherever possible, rather than focusing on solely cutting costs in the short term.

As the Treasury sets out its plans for public services for the next four years in the *Comprehensive Spending Review*, it is time to rebalance the role of efficiency in public service provision, moving to measure success in terms of outcomes for people rather than the 'false economy' of short-term cost savings to the Exchequer.

1. Introduction

'The worst enemy of life, freedom and the common decencies is total anarchy; their second worst enemy is total efficiency.'

Aldous Huxley

Brave New World presents a dystopia where the human spirit is subverted by the state as it strives for ever greater efficiency.¹ Is the Government's market model, combined with efficiency pressures from the centre moving our local public services in this direction? Common sense tells us that an approach to public policy that values narrowly defined efficiency above all other goals will ultimately be self-defeating. Unlike buying toilet seats or missiles, the success of public services depends on meeting diverse and complex needs. What ultimately matters here is effectiveness.

Nevertheless, the current government pressures on local public service commissioners places efficiency – defined in a narrow financial sense – at the heart of public service contracting, and increasingly attempts to achieve this through market mechanisms and mimicking private sector 'discipline'. Compounding this is the effect that the Gershon efficiency review – with its target of £21 billion pounds of efficiency savings over three years – is having on decisions about local public services.²

Initial evidence shows that pursuing short-term financial-efficiency gains through competitive market models squeezes out the broader considerations of positive social and environmental outcomes that would enable our local public services to better serve our communities. The danger in the efficiency game is that it will create a 'race to the bottom' in public service provision, much of which is targeted at the most vulnerable members of our society. When it comes to our local public services, is the Government focus on efficiency undermining effectiveness?

We think the answer is 'yes'. This is an inevitable, if unintended, consequence of the approach the Government has developed, particularly when combined with the cost-saving pressures created by the Gershon review. In this area, radical rethinking is needed. Ultimately, genuinely efficient and better public services must focus on maximising *positive outcomes* defined in terms of *public benefit*, rather than solely minimising costs. Driving down costs may save money for the public purse in the short-term, but this is a false economy when viewed in terms of responding to the changing and complex needs of people and communities in the long term.

In this paper, we look at the assumptions behind the current models of efficiency and of market-centred

public service reform as they apply to commissioned and tendered local public services. We present four key pillars of this thinking, showing how these are largely myths. We use examples from locally provided public services – services for children, the care of those with mental ill health, and for older people – and show that it is often those at greatest risk that have most to lose from the Government's efficiency and cost-saving agenda. While health and education, the universal services, have benefited from increased investment, the measure of a civilized society is the way it treats its most vulnerable members; and it is to these citizens that our examples relate.

We then offer several solutions that move towards a new *public benefit* model of public services at the local level. These draw upon practical models **nef** has developed in collaboration with public and voluntary sector partners. They place outcomes for service users and communities above narrow financial considerations to achieve 'real' value for money.

This comes at an important time of policy debate and renewal. The three-year Gershon review period is reaching completion and a new approach is required. The upcoming *Comprehensive Spending Review* will set budgets and targets over the coming four years across the entire public sector. HM Treasury's commitment to rationalise the number of public service agreements (PSA) targets and create new local service indicators provides a welcome opportunity for fresh thinking about local services. It is time to focus on what matters most – effective services that meet local needs and improve well-being for service users and their communities.

2. Myths and realities: the market model and the pursuit of efficiency in commissioning local public services

'Investment accompanied by reform' has been the post-1997 Labour mantra for public services. Reform has meant enhancing efficiency and productivity. These are laudable goals, but there are clear problems, especially when looking at the services local councils purchase to meet community needs.

First, the Government's definition of efficiency is too narrow and mechanistic, neglecting much of the value that public services can and do create. Second, although the Government emphasises the importance of effectiveness – in terms of the outcomes of public service provision – in practice this often comes a poor second to concerns over efficiency. In part, this is because it is relatively easier to measure (financial) efficiency compared with effectiveness to people and society. When putting the cost-saving imperative created by the Gershon review into action, efficiency has eclipsed effectiveness.

Below, we lay out the four pillars of the current model that rest on myths. These must be challenged if we are to pursue a better approach to our locally commissioned public services.

The four myths:

1. Market failure is the justification for intervening to meet needs.
2. Though the market has failed to meet needs, market disciplines like contestability and competition are seen to be the best ways to improve public services.
3. Centrally imposed efficiency targets (i.e. the Gershon review) are appropriate for improving local public services.
4. The *value for money* model ensures the efficiency and effectiveness of these local public services in practice.

Myth 1: Market failure is the justification for state intervention to meet needs.

'I am suggesting today that... our mission must be relentless: to strengthen markets to maximise efficiency.'

Gordon Brown, Chancellor of the Exchequer 2003³

The current government's approach to the public sector is centred upon the assumption that the state should intervene to meet needs only where there is a clear 'market failure'. We argue that where public services that meet social and human needs are at stake, this does not hold. Clearly, government can, and does, intervene for a range of equity and social justice reasons.

In basic economic terms a market failure occurs where a market exchange is not 'Pareto efficient', meaning that all resources are being utilised and no one person can be made better off without another being made worse off.⁴ The Treasury outlines three instances where market failure can occur and where state intervention is therefore justified:

1. Where there are spill-over effects from the actions of individuals and firms, which cause harm (or benefits) to wider society (externalities).
2. Where markets are dominated by certain actors with the ability to influence prices and outcomes (market power or monopolists).
3. Where economic actors do not possess all the relevant information to inform their decisions (i.e. asymmetric information – where one party has more access to information than others).⁵

'Externalities' mean that the price of a good or service does not capture the knock-on effects of a transaction.

Neither are the extra benefits valued in the price paid, nor are the negatives or detriments caused paid for by the perpetrator. The fact that externalities aren't captured in price prevents market actors from producing many goods that would bring benefits to society. For example, a private individual who plants trees brings benefits to the local community, but receives no special personal benefit herself. As a result, fewer people will take action to plant trees to create benefits for all. On the other hand, a company that pollutes a river may be able to escape the economic consequences of its action and doesn't pass on the huge costs to society in its low price. Again, there will be an 'overproduction' of such social 'bads' since those responsible do not bear the full economic consequences of their actions.

Government therefore has an important role in both generating positive externalities and ensuring that market actors don't pass on negative externalities for society to deal with.

In terms of market power, the notion of 'perfect competition' – where no single economic actor can influence market prices or outcomes – has never been more than an abstract concept: market power and imperfect competition is the norm, not the exception. Similarly, the prevalence of asymmetric information has become increasingly accepted, and it is now understood that this, too, is the norm rather than the exception.⁶

The reality

Given that externalities are widespread, that market power is the norm and that information asymmetries are endemic, there are vast swathes of economic life, rather than odd exceptions, where government intervention is justifiable on the basis of market failure.

However, with our vital public services it would be a struggle to find many people outside the Treasury who would consider the public provision of health and education to be only justifiable on the basis of market failure and the inability of the market to produce Pareto efficient outcomes.

In these areas, Pareto efficiency says nothing about how equitably resources are allocated and meet needs, in order to protect the vulnerable and contribute to the well-being of society. Meeting needs for housing, health, care and education are not merely provided by the state because the market doesn't. A social contract exists that spells out rights, responsibilities, and social justice. Some areas of life should remain outside of the market mechanism, for the market cannot – even if 'corrected' – deliver the outcomes we, as a society, want or need.⁷

As we shall see in the next section, reducing the discussion about intervention to narrow ideas of market failure has been translated into practice in the notion that where markets don't exist or have failed, the best outcomes can be achieved by mimicking market mechanisms. This is strange indeed: governments should intervene where markets have failed, but the solution to this problem is to mimic the very market system whose 'failure' made the intervention necessary in the first place.

Myth 2: Market 'disciplines', including commissioning and competitive tendering, are the best ways to improve local public services.

While the first myth describes the basis upon which the Government justifies intervention in the economy/society, Myth 2 focuses on the growing trend towards competition and contestability in commissioning as ways to adhere to market discipline to pursue greater efficiency and productivity.

*'Private sector firms generally face a similar set of managerial issues [to the public sector], but the market environment in which they operate usually forces them to adopt behaviours that mitigate the associated problems... Accordingly, a key part of the strategy to improve public services productivity has to be to find ways of providing the same clarity and focus in the absence of market mechanisms to do this.'*⁸

For the Government, the focus on efficiency has meant creating competition to supply public services, much like a commercial market. To have one monopolistic source of 'supply' (the public sector) to satisfy a range of diverse customer demands will be highly inefficient, hence the

'purchaser-provider split' which lies at the heart of the commissioning of public services.⁹ In this framework, public sector commissioners say what goods or services they are seeking and then open up the market to find the most appropriate supplier.

This market model is being applied at both national and local levels of public service provision. The Local Government White Paper, published in October 2006, explicitly calls for more commissioning and competition in locally provided public services as the best means to enhance efficiency, quality and innovation.¹⁰ Across the UK, there is evidence of local authorities adopting more contract-like arrangements for commissioned services.¹¹

The problem of motivation and principal–agent theory

The assumption is that people working in or for the public sector are motivated in the same way that people in the private sector are thought to be motivated: by the prospect of financial gain or vice versa. To raise standards – and to drive down costs – it is necessary to pit people and groups against one another, with competition, the

pursuit of self-interest and the mimicking of private sector 'disciplines' ensuring that standards are driven up and costs are driven down.

The theory that lies behind this assumption draws heavily on economists' work on the 'principal–agent problem' in the private sector and how it can be resolved.¹² This thinking seeks to explain how overall objectives (i.e. those of the principal) can be achieved when the agent who is charged with realising these goals may be pursuing different objectives. The most obvious manifestation of this can be seen in areas such as performance-related pay, or in the linking of senior management remuneration to movements in the company's share price, both of which seek to align the incentives of agents to the primary objective of increasing profits or creating shareholder value through a rising share price.

Government (the principal) similarly seeks to align the incentives facing service providers with its own by contracting out services. Competitive tendering encourages those bidding to bear down on costs – a key government objective – while drawing up contracts that link payments to performance in terms of service delivery. This should, in theory, drive up quality – another key objective.

It is no longer seen as sufficient to rely on a public service ethos, even when public service professionals clearly have both codes of professional integrity and non-monetary motivations for entering the caring professions. Rather, the assumption is that, just as in the private sector, people are fundamentally motivated by self-interest, best encouraged with financial incentives and carefully constructed – and monitored – contracts for services. Motivations intrinsic to the work have no place in this way of seeing the world and as such, bearing down can have a profound negative effect on the very thing that makes public services work – the caring of their people and willingness to go the extra mile.

The Government recognises the danger of undermining the public sector ethos with this approach but concludes that this is less of a problem than that of motivating public sector employees or contractors who do not share this ethos.¹³ The danger is that a self-fulfilling prophecy will be created, where the new incentives of the system attract providers that are motivated by financial gain, and drive out those that are motivated by the public service ethos and helping others.

The reality

Competition does not always lead to optimal results. This is because of transaction costs (and who bears them) as well as the importance of trust in economic relationships – especially those economic relationships set up to meet complex human needs.

Transaction costs

Unlike the abstract realm of 'perfect competition', transaction costs always exist in the real world. In this regard, competitive tendering, and negotiating, enforcing and monitoring contracts are costs borne by service commissioners, providers and, ultimately, the Government and the taxpayer.

Case study: Hampshire County Council

Hampshire County Council's *Supporting People* programme carried out a value-for-money evaluation of the costs of competitive tendering versus renegotiating contracts with existing suppliers.¹⁴ They found that competitive tendering added significant costs to overall contracts because of the administration and transaction costs involved. One commissioner commented that:

'When you factor in staff time you do have to question the level at which it becomes viable to tender. Each individual tender we ran last year took up ten staff days when you consider evaluation and inviting people to interview. That adds a few thousand pounds to the overall cost...my view is that there is more than one way of achieving Value for Money. Competitive tendering is only one option that should be considered, it is not the universal panacea that some would consider it to be.'

Public Service Commissioners must research and understand the service market, develop service specifications, consult with users and providers, write pre-qualification questionnaires, read through lengthy applications, attend interviews and deal with legal and financial issues involved in setting up a service.

Equally, the contracting model is expensive for providers who may at any time be involved in a number of potential bids, none of which guarantee success (and even when they do, the time spent on the bid writing is not incorporated). Smaller providers – whether small and medium-sized enterprises (SMEs) or community voluntary sector groups – may have had no experience of such tendering processes and may find themselves failing at the pre-qualification questionnaire stage when asked to prove their financial probity. In addition, being good at the game of contracting doesn't necessarily mean an organisation is the best at meeting local needs.

The cost of repeatedly jumping through these same hoops also threatens to undermine the financial viability of such smaller organisations. It can divert resources and leach management time away from managing the quality of care given to users. According to **net**'s research in this area, the overwhelming majority of service delivery organisations note that measuring the quality of outcomes for service users is important to them but is pushed aside in favour of the pressing needs of contract upheaval and tendering. This is a clearly a perverse effect of the contracting and competition regime. None of this seems particularly 'efficient' in a meaningful sense.

Trust

The competitive approach also ignores the benefits that can be obtained from establishing and building on long-term relationships characterised by trust. The importance of trust in underpinning and shaping economic and social outcomes has been increasingly recognised in recent

years.¹⁵ A popular means of framing the concept of trust in economic life is that of 'social capital', which Putnam (1993) defines as:

'...features of social organization, such as trust, norms and networks that can improve the efficiency of society by facilitating coordinated actions'.

In simple terms, if I ask you to provide a service for me in a particular way, and through our established relationship you understand what is required and how it is to be achieved, there is no need for a) a complex and expensive commercial tendering relationship; b) the delivering institution to exert time and energy developing the skills needed to perform the role; and c) the commissioning body to closely monitor performance so as to ensure compliance.

Trust-based relationships are thus able to eliminate or mitigate the principal–agent problem, since both principal and agent are seeking the same goals, and the longevity of the relationship and shared acceptance of societal norms ensure that both parties have a shared understanding of how these are best achieved.

In more complex network situations, where there are a number of economic actors involved, the coordination of collective action – i.e. when the fulfilment of a particular task requires a range of different people or groups to act at the same time – is greatly facilitated by the existence of trust, or social capital. Put simply, I will be more prepared to 'jump' if I trust you to do likewise.

Focusing on competition rather than cooperation means that the Government's approach to commissioning local services directly reduces the level of trust (or social capital) in the system. The alternative is a complex, bureaucratic and expensive system of contracts to control behaviour, which may or may not succeed, but is likely to be less genuinely efficient than trust-based, network solutions.

In a seminar **nef** held with London-based voluntary sector organisations contracting for public services there was considerable cynicism about this issue. One local provider commented that he 'no longer considers it a partnership of equals between himself and the commissioner' and this affects every aspect of how he presents himself and his organisation, including, ironically, how he presents his organisation's true running costs:

'I have no incentive to reveal to them [the commissioner] the true costs of my organisation, because they could simply use this to justify further cutting funding.'

Moving from grants and trust-based relationships to arms-length contractual and competitive tendering can limit the quality and quantity of information that flows between the parties and curb their ability to work together to find solutions, raise quality and meet needs.

It is thus unsurprising that the Audit Commission report on third sector commissioning found little real engagement between commissioners and providers in terms of developing their understanding of service needs:

'Commissioners were generally positive about involving the local voluntary sector in developing their understanding of service needs. However, most of the positive comments were general observations that strategic engagement with the voluntary sector was a good thing. We found few practical examples of strong engagement. Voluntary organisations were more likely than councils to mention problems and tensions... Councils conducted most of the engagement with the voluntary sector through partnership boards (children's trusts, crime and disorder reduction partnerships for example), rather than any direct engagement with individual service providers. There was little evidence of tangible positive benefits accruing because of this strategic engagement.'¹⁶

The competitive model not only reduces trust and cooperation between commissioners and providers but also between providers themselves, who have little incentive to share ideas and develop innovative forms of best practice. As knowledge and innovation become key to winning contracts, so third sector organisations will protect or copyright the insights gained from their experience. Unsurprisingly, a competitive commissioning model results in competitive behaviour. In this situation, it is the service users that lose out, with agencies jockeying for position, contracts, and their 'business' whether or not it is in the user's best interest.

Myth 3: Centrally imposed efficiency targets can help deliver better and cheaper local public services.

While few would argue that public services should be delivered inefficiently, the identification of potential efficiency savings in the Gershon review, and the pressure on all sectors of the state to achieve them, has led to a relentless downward pressure on costs, much in the way that shareholder demands for short-term profits lead companies to cut costs, with a resulting negative impact on longer-term objectives and sustainability.

Although the Government has made it clear that a 'service cut' or a reduction in inputs that leads to a decline in quality cannot count as an efficiency gain, a recent review of the efficiency agenda by the National Audit Office raised questions over whether efficiency gains were affecting service quality in practice:

'Most of our sample projects measure efficiencies based on a reduction in the cost of inputs. In order to demonstrate that true efficiencies have been achieved, measurement methodologies should contain measures of quality and output that show these have been maintained despite the reduction in input costs.'

Where quality measures have been established, departments have not always been able to confirm that service quality has been maintained.'¹⁷

Clearly, the efficiency drive has had impacts on service quality.

The reality

The rationale for Gershon is an assumption of massive inefficiencies within the public sector.

In practice, the Gershon cost-saving imperative both exacerbates the problem of focusing on easily measurable throughput or outputs rather than quality or outcomes, and ensures that those commissioning public services are obliged to weight cost considerations above any others. Reducing price is the easiest way to demonstrate a 'cashable' Gershon efficiency saving; it is a simple upfront cost reduction. In a public service context, particularly where services are being procured for the most vulnerable members of society such as with social care, this is a worrying trend.

As one procurement official in a London Borough said:

'The Gershon savings driving us need to be cashable, i.e. more efficient use of staff time or less staff needed in undertaking the procurement process such as electronic invoicing or joint procurements, or savings on the contract price... Unless we can measure a specific cost reduction to another council service as a result of the contract, thus lowering our budget requirements overall to provide all council services, it doesn't count.'¹⁸

In addition, chasing efficiency savings to a particular service or council department reinforces silos and

The Gershon Efficiency Review¹⁹

Commissioned by the then Prime Minister, Tony Blair, and the then Chancellor, Gordon Brown, the Gershon Efficiency Review focused on the Government's objective to "release resources to fund the frontline services that meet the public's highest priorities by improving the efficiency of service delivery." The report, published in 2004, identified the opportunity to make £21.5 billion of sustainable efficiency gains across the public sector by 2007/08. Of this total, at least £6.45 billion would be achieved by local government in England – equivalent to 7.5 per cent of its 2004/05 baseline expenditure, or an equivalent of 2.5% savings *per annum*. This figure has been adopted as the official target for local government.

An efficiency gain is defined as 'raising productivity and enhancing value for money'. A gain is made when, for a given area of activity, an organisation is able to:

- Reduce inputs for the same outputs (representing a cashable gain; i.e. money is released that can be reused elsewhere);
- Reduce prices for the same outputs (representing a cashable gain);
- Get greater outputs or improved quality for the same inputs (representing a non-cashable gain; i.e. money is not released); or
- Get greater outputs or improved quality in return for a proportionately smaller increase in resources (representing a non-cashable gain).

prevents joined-up approaches to meeting needs or achieving value across a community. In practice, 'cashable' savings to other council departments (for example meeting employment needs whilst providing mental health services) are currently not tracked by local authorities.

Hence a paper-printing social firm that employs and provides training to people with mental health problems might lose its bid to print council stationery because it has higher unit costs than a larger commercial provider. There is no opportunity in the standard commissioning process for the social firm to demonstrate the value and potential savings for other departments within the council or wider public sector (including, for example, the local Primary Care Trust) that may accrue from employing people with mental health problems.

Genuine efficiency gains, in contrast, would both take account of the effectiveness of outcomes in a broader sense – including wider public benefit factors – and would be driven by improvements in effectiveness rather than reductions in cost.

Myth 4: The value for money model ensures that efficiency and effectiveness are both pursued.

The Government's approach to efficiency and productivity in the provision of public services is, as we have seen, increasingly driven by the belief that importing models from the private sector is the best way of driving up standards and holding down costs. While the approach may well succeed in lowering costs, the question that has been raised – not least by the National Audit Office and Audit Commission – is the impact this has on effectiveness. In fact, if services are not effective, they may just do more harm than good.

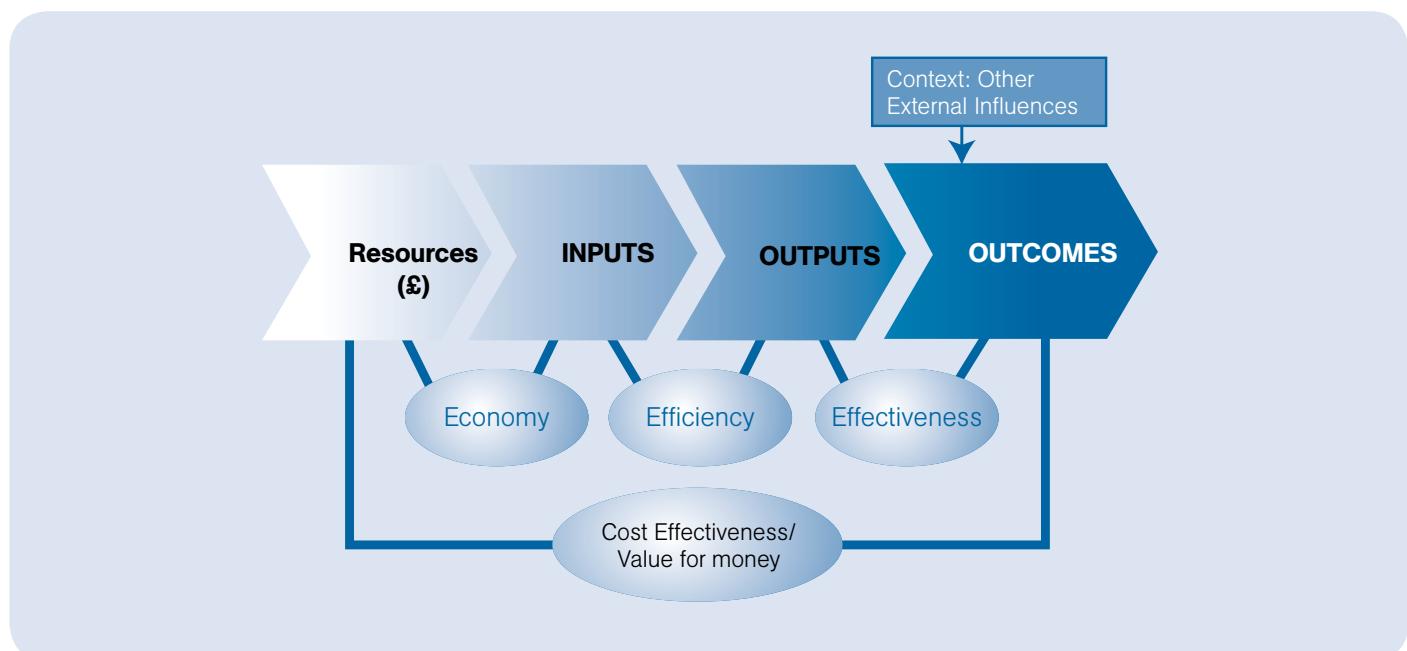
At the heart of the Government's approach is its *value for money* model (Figure 1), which is assumed to promote both efficiency and effectiveness – for example, how much effectiveness can be achieved for a given level of resource input.

This model has money – taxpayer's money – at its heart. Resources flow in to the model in the form of pounds sterling and these buy certain 'inputs' (for example, numbers of hours worked by professionals).

Measuring the outputs that can be created from these inputs (e.g. the numbers of patients treated or meals on wheels delivered) tells us about the 'efficiency' of the service. Finally, the outcomes created from these outputs – people with better health – represents 'effectiveness'. Outcomes can also be influenced by context or other external influences.

Overall, the relationship between outcomes and tax payers' money would tell us about the true value for money (VFM) of the service. As the Regional Centres of Excellence (charged with overseeing the local authority efficiency agenda) state in their description of the model, 'VFM is high when there is an optimum balance between successful outcomes, high productivity and relatively low costs.'²⁰

Figure 1: The Government's value for money model²¹



The reality

In practice, however, it is much easier to measure short-term (financial) inputs and outputs like the numbers of people served than it is to measure the outcome or the 'whole life' cost of the service. This focus on what is easily measurable has been exacerbated by the added ingredient of the Gershon review, which demands cost savings for a given level of service provision.

The most recent and comprehensive survey of the decision-making processes undertaken by commissioners and procurers of public services can be found in the Audit Commission's recent report on commissioning and the voluntary sector. The report found that:

'When asked about cost effectiveness for contracted services, many commissioners told us that they currently rely on price comparisons at the bidding stage, usually on a unit cost basis. ...'²²

This approach is flawed even within the confines of the government's VFM definition, which defines VFM as 'the optimal combination of whole life costs and quality to meet the service user's requirement'. The *annual* unit cost of a service or its 'price' tells us very little about the true costs and benefits of a service over a three to five-year period, for which many social services are commissioned.

Price seems to be an almost universal proxy for whole life cost in the day-to-day world of local authority procurement. The exceptions are in longer-term construction contracts and public works where whole-life costing formulae have been created by a variety of organisations, including HM Treasury which has developed a VFM tool for use in private finance initiative (PFI) contracts.²³

Case Study: Revolving Doors

For 14 years, Revolving Doors Agency has been the UK's only charity dedicated to improving the lives of people with mental health problems who have been arrested or imprisoned. Their mission is to create opportunities for people caught in the cycle of crisis, crime and mental illness to transform their lives. They have won national awards for their service development model: 'Link Worker Schemes'.

These services work across all stages of the criminal justice system (police, courts, prisons and community), providing a combination of emotional and practical support to enable people with Link Worker Schemes to navigate and maintain engagement with support services. This work has highlighted high levels of hidden and unaddressed needs and demonstrated that people with the most intractable set of problems can be reached and effectively supported.

Despite the Government's expressed commitment to promoting voluntary sector involvement in the delivery of public services, Revolving Doors has had to withdraw from direct service delivery of its Link Worker Scheme as tightening budgets and reductions in unit costs by local authorities and primary care trusts (PCTs) made the continued delivery of services by such a specialist provider unviable. In particular:

- *Supporting People's* national programme has led to local commissioners seeking considerable cost savings through having fewer larger providers and more generic services. One commissioner, for example, tendered for a single lead provider across the county, with an hourly rate of £20. This was £5 an hour lower than the hourly rate currently achieved by the county's largest provider.
- PCTs are seeking considerable cost savings, particularly from mental health services. For example, two London PCTs have recently asked for a reduction in mental health services of 5 per cent and 7.2 per cent respectively, which translates into a reduction of £4 million each from mental health services. Revolving Doors Agency felt that such cuts would make achieving full-cost-recovery funding from mental health commissioners increasingly difficult.

Research by the London Centre of Excellence on 192 public authorities in London found that whilst almost half of the organisations claimed to be using whole-life costing models, none were able or willing to demonstrate their model or how it was used in the procurement process.²⁴ The implication is that very few organisations commissioning public services use any kind of longer-term costing tool when making procurement decisions.

Clearly, it is easier to measure price than whole-life costs, quality or results. But people, particularly the most vulnerable members of our society, have complex and evolving needs, which cannot be valued using the simple and static market mechanism of price.

What price is it worth paying to enhance the confidence of ex-drug users so they are able to take a course at their local college? Or to help someone recovering from mental health problems to volunteer in a garden centre? And, perhaps more importantly, what guarantee, when a service is commissioned, does the price of the service really offer that such outcomes will be achieved?

The threat to smaller local and specialised service providers

This narrow VFM model is bad news for service users who depend on services that are best provided by niche providers, or organisations that create benefits that are not being paid for in the service price. While the Government has made it very clear how important it regards the contribution of smaller, locally based community and voluntary sector groups²⁵ to the creation of social capital and economic regeneration, when contracting and price take precedence, these are the organisations that most often suffer. A considerable body of evidence shows these negative effects.

- A recent analysis of Charity Commission data by the National Council for Voluntary Organisations (NCVO) highlights the rapid growth of many large charities and the decline in the income of many small or medium-sized charities. This is despite the fact that 56 per cent of the third sector are small community groups with less than £10k income (87 per cent have less than £100k).²⁶ The Department for Communities and Local Government reported the same pattern.²⁷
- The Charity Commission's recent report suggested that medium-sized organisations are particularly at risk and that there is a danger of polarisation within the third sector with the emergence of 'super charities' winning more and more government contracts at the expense of smaller groups.²⁸
- In Children's Services, a recent report by the National Association for Voluntary and Community Action (NAVCA) found that the voluntary and community sector is experiencing widespread cuts to preventative services for children and young people. The survey, of 173 local authorities over 86 local authority areas, found that:
 - 68% of the VCS report cuts in the last 12 months.
 - 40% of the VCS report that efficiency savings are the single greatest cause of cuts.
 - Only one respondent reports increased local investment in preventative services (0.8%).

The wider public benefit and positive externalities

Recent research points to the positive impact of small local voluntary and community organisations in the UK and abroad.²⁹ Yet the Government's efficiency agenda

fails to take into account these important social, economic and environmental impacts, or 'positive externalities'.

Remarkably, guidance accompanying the Gershon efficiency review from the Office of Government Commerce (OGC) explicitly states that benefits to the wider community should *not* be considered as efficiency gains:

'3. Benefit to the wider economy or valuing the public's time.'

We do not recommend that departments adopt either approach, since savings do not accrue to the public purse.³⁰

The fundamental point is that wider benefits to the community, be they social or environmental, are not captured in the current model of competitive contract tendering which is focused mainly on the basis of cost and the achievement of narrowly defined targets. Ironically, it is this presence of externalities that, in the market failure model (Myth 1), makes state intervention

necessary in the first place. That is, the social and environmental benefits of a broader and more holistic approach to efficiency are likely to diverge from the private benefits that accrue to each individual provider: the provider cannot 'capture' the economic value of these benefits, and they will therefore be 'underprovided' or more likely not provided at all.

Providers bidding for contracts, and the commissioners designing these contracts, have every incentive to focus on that which is easily measurable (for example, costs) and little incentive to focus on less measurable factors or on those which are of wider public benefit.

The creation of these positive externalities is arguably one of the most important tasks of government, both local and national, yet the competitive model for the delivery of public services that has been developed undermines its ability to deliver these wider public benefits.

Summary

Taken in combination, these four shaky pillars of the Government's approach lead to a narrow view of efficiency in public services:

- The assumption that government intervention is only justified where there is a market failure fails to take account of what most people value in the public sphere, particularly the building of a sense of community and society and the maximisation of broad public benefits.
- The assumption that public services are best delivered through the market mechanism and the imitation of private sector incentive systems:
 - denies and undermines the public sector ethos and professional integrity as a motivating principle;
 - builds higher transaction costs directly into the system;
 - undervalues the importance of trust and long-term relationships in coordinating behaviour; and
 - makes it likely that competing organisations are judged according to the most easily measurable criteria – namely cost.
- The assumption that efficiency gains can be identified and imposed from the centre, when added to this model, greatly increases the tendency to focus on reducing costs above all other considerations. By favouring large organisations that can benefit from economies of scale, this is also having a negative impact on the very organisations – small community groups – that the Government has identified as the most efficient vehicles to create social and economic regeneration.

- The assumption that the Government's VFM model measures efficiency and effectiveness correctly is flawed. Easily measured financial indicators of efficiency will be more heavily weighted than less easily measured indicators of effectiveness, particularly in the context of the Gershon review. Furthermore, there is not even an attempt to measure many of the broader social benefits of public service provision, ensuring that these positive externalities are not valued and will therefore be under-produced or not produced at all.

3: Redressing the balance – pursuing efficiency without undermining effectiveness

The key to meeting local needs is ensuring that efficiency does not eclipse effectiveness. Below are three practical ways that this is happening now, based on **nef**'s work in local areas across the UK. These new ways of working help to refocus public services on public benefit and the long term well-being of users and communities. These models are being put to the test and put into use in the day-to-day reality of designing, procuring and monitoring public services.

1. Efficiencies of the 'small scale'

As we have seen in Section 2, the Gershon efficiency savings agenda is driving the consolidation and aggregation of contracts, in seeking 'scale efficiencies'. The local Government White Paper is explicit in its requirement for increased 'sharing of services' as a means of improving efficiency.³¹ Rarely a month passes without the Confederation of British Industry or one of its members calling for more 'shared services' and outsourcing as the key means for improving efficiency.³²

Whilst it is not in doubt that some back office and transactional services can be shared to create scale efficiencies, local authorities must be concerned with effectiveness of services at the *local* level, and in some cases aggregating or 'going bigger' doesn't make sense. In fact, the 2000 Local Government Act's 'power of well-being' gives all local authorities 'discretionary power to do anything they consider likely to promote or improve the economic, social or environmental well-being of their area'.³³ Michael Lyons's emphasis on 'place shaping' follows the same logic.³⁴ Ultimately, local authorities are accountable to the citizens within their areas, before the efficiency pressures of national government. If services don't work well, saving 2.5 per cent of HM Treasury cash is cold comfort.

Looking beyond short-term efficiency can deliver better long-term benefits. **nef**'s work with local areas across the UK has shown that procurement can deliver additional value and public benefit when a longer view of efficiency and effectiveness is taken – particularly in more disadvantaged areas. The following examples show how disadvantaged areas can gain from smarter commissioning and procurement:

- A Cornwall Food Programme switched to smaller local providers, generating £47,000 more per year for the regional economy.³⁵

- Northumberland County Council bucked the aggregation trend by redirecting 10 per cent of its external spend to local suppliers. This generated an additional £34 million for the local economy.

However, the value of using locally based providers to spark local economic regeneration as a positive externality of procurement is *not* given scope in the current efficiency regime. Thus, what is foregone is:

- the economic multiplier effects, particularly if a provider is embedded within an area experiencing economic disadvantage and employs local people or keeps money and ownership circulating locally;
- the social impact, such as ease of access and continuity of services for users; and
- environmental impacts, such as reduction in traffic and carbon emissions.

If the primary concern of local authorities is the creation of sustainable local communities and resilient local economies they need to consider 'scaling down' just as readily as they consider 'scaling up'.³⁶

Ultimately, of course, all the inputs to our efficiency equation are determined by planetary resources – water, air, carbon, biodiversity etc. Any concept of efficiency in seeking public benefit needs to involve the use of these scarce resources in the most efficient way possible.³⁷ Public procurement, whether it involves purchasing goods or services, represents a massive opportunity for creating long-term improvements in environmental efficiency as is detailed in the Government's sustainable procurement action plan. Yet, as previously mentioned, whole-life costs are something of a myth in the reality of public sector procurement of services.

2. Using people-based assets in communities makes services more effective and efficient: the co-production solution

In addition to foregoing the important economic and environmental benefits of a more holistic approach, the market-based, cost-efficiency-driven model of local services loses the most important ingredient of any public service: people. Whether they are direct beneficiaries, their families or the wider community, the current VFM model is blind to the resources that people and communities can add to making services not just cheaper, but better.

People, families, communities and neighbourhood groups – civil society – should be understood as a second, underlying non-market economy, which is widely ignored by economists but is vital to the functioning of the market itself. This non-market economy is actually much *more efficient* at certain activities that the public sector should value most highly, including: raising children, caring for older people and transferring language and culture.³⁸

For public services to leverage these assets, they need to be 'co-produced' with people. 'Co-production' involves sharing responsibilities and knowledge – of both service design and delivery – between professionals and users, and sometimes with the user's family and neighbours.³⁹ A co-production approach recognises that everyone has assets that need to be engaged to make society work. This approach requires a relationship of reciprocity and partnership between commissioners, providers and users that recognises each has a vital role to play in achieving the best outcomes.

Contestability, or opening up markets, not only focuses commissioners on short-term inputs for service provision as opposed to longer-term outcome for service users, but also reduces the involvement of service users in the design and delivery of those services as the focus of the commissioner centres on developing a competitive service market rather than understanding and developing relationships with users and their communities.

Effective doctors know they cannot deliver healthcare to patients, effective teachers know they cannot deliver

learning to students. In each case, these are relationships where both parties have a part to play. This is also true of effective police forces who know they cannot deliver community safety without resident participation.

Co-production relationships between service users and professionals bring broader benefits. In 2003, the Department of Health commissioned a major research programme into patients' involvement in their care entitled *Health in Partnership*.⁴⁰ The programme consisted of 12 separate pieces of research and produced consistent and clear results, which included the following:

- Improved health outcomes at the individual level stem from patients' involvement in decision-making and in self-management.
- Involvement in decisions about their care, as well as experience in self-managing, increases patients' satisfaction with the healthcare system.
- When patients are involved in co-producing their services, they have less anxiety and greater understanding of their healthcare needs.
- Involving patients increases clinician's satisfaction with their role.
- Both patients and clinicians report an improvement in the relationship between them following greater patient involvement in decision-making and self-management.

At present, the efficiency monocle makes co-production models appear more time consuming, and perhaps more expensive, since the deeper and longer-term benefits take time to surface and require measuring outcomes. The current efficiency regime blocks co-production on these grounds, whereas a public benefit would require paving the way for these approaches.

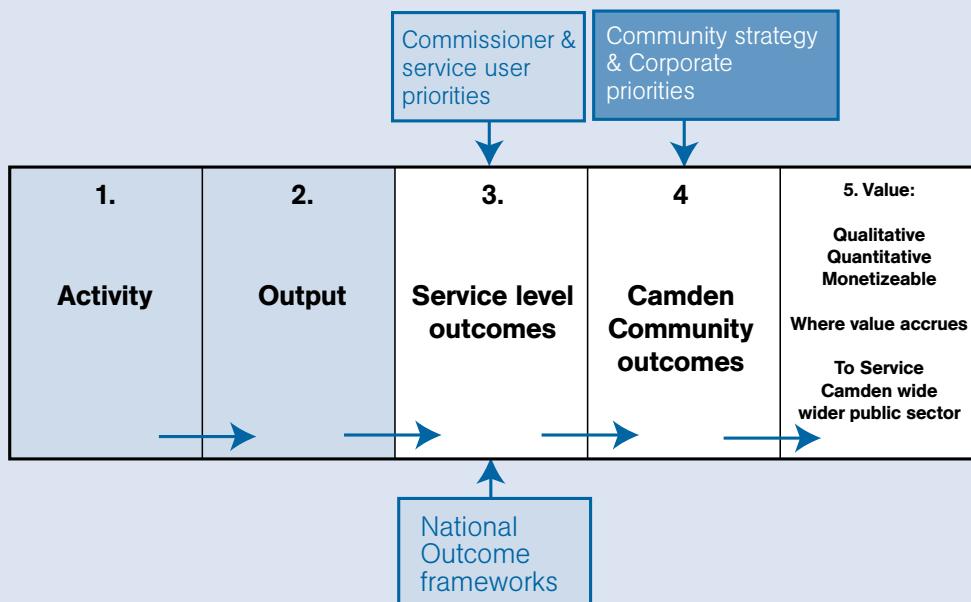
3. Pursuing 'public benefit' for efficiency and effectiveness: sustainable commissioning and social return on investment

We have seen how the current VFM approach, interpreted at a local level and coupled with the budgetary pressures created by Gershon, leads to neglect of social, economic and environmental inputs and outputs that are inherent in all public service interventions. With individual companies and third sector groups competing for contracts, organisations have little incentive to increase wider public benefits (such as local economic regeneration), nor is there any incentive to minimise wider social costs (like polluting the environment), since contracts are not awarded, and performance is not assessed, on this basis. The added value created across other council budgets or the wider public sector is neglected. Instead, there is a

bias towards reducing short-term inputs (price) over long-term outcomes (whole-life costs and benefits).

A social return on investment (SROI) approach offers one way to track the important outcomes that are created when a service is commissioned. SROI relies on measuring service outcomes to compare the financial investment made by an organisation with the benefits created for stakeholders, rather than just the buyer of the service.⁴¹ SROI looks at outcomes in the longer term and monetises the value of outcomes in terms of market values or values to government or other 'proxies'.

Figure 2: The sustainable commissioning model – outcomes framework



nef has put this idea into practice in partnership with the London Borough of Camden. The result is a *sustainable commissioning* model which values the wider triple bottom-line (social, environmental and economic) impacts providers claim they can create, on top of the agreed service level outcomes. These outcomes are set out at the tendering stage and are tracked over the course of the contract so that decisions can be made on more than price alone, and there is increased understanding of the impact of interventions. The model is designed to be used by the public sector commissioner, easing the burden of administration on providers.

The Outcomes Framework (Figure 2) illustrates the approach, describing:

- How activities and outputs (Columns 1 and 2) delivered as part of the service contributed to the desired service-level outcomes (Column 3) established by end-users of the service, and commissioners.
- How the service level outcomes relate to broader priorities (called 'Community Outcomes') (Column 4) established by the Council in its policy and strategy documents.
- How the Council will monitor the value and benefits created through delivery of this service (Column 5). Value can be measured in qualitative, quantitative and monetisable, or financial, terms. Value accrues to the service, but also across the Council, its partners in community and to the wider public sector.

The model has been used successfully to tender a mental health service contract worth £2 million over three years. The winning tender consortium involves a national provider with a local subsidiary in Camden and

two smaller, locally based charities that will use a co-production approach to their services.

The consortium showed the value of their approach in their tender, demonstrating the positive social, economic and environmental outcomes for Camden as well as for individuals using the service. The lead procurement officer involved noted that the model and the other activities had enhanced the quality of the four tender responses, saying of the winning tender that it was 'one the best I have ever seen'.

This kind of approach could help local authorities develop their understanding and delivery of 'non-cashable' efficiency savings and provide an alternative to cashable savings based on reducing budgets.⁴² Table 1 shows the savings that can be associated with achieving positive outcomes in a mental health context.

The model also stimulates innovation amongst all providers (in-house, private and third sector) to achieve the key local priorities of a public agency. In particular, the model places the wider, triple-bottom-line impacts that some providers may bring to a service at the core of the commissioning process. This contrasts with a social clause approach or local authorities' internal scrutiny procedures. Rather than a provider being required to meet certain *minimum* environmental or social standards in the delivery of the service, providers are incentivised to *maximise* such environmental and social impacts in the presentation of the tender itself. The so called 'added value' is seen as a core aspect of the delivery of the service and weighted accordingly.

As such, this approach has the potential to create a 'race to the top' in terms of impact and effectiveness, which contrasts sharply with the alternative 'race to the bottom' that prioritises cost over all other considerations.

Table 1: Positive mental health outcomes and savings to the local and wider public sector

Outcomes	Indicators	Savings (costs associated with mental health)
Enhanced psychological well being	<ul style="list-style-type: none"> Service users report increase in well-being Service users report reduced isolation Service user are integrated in to mainstream services and are independent of the Day care 	<ul style="list-style-type: none"> Increased frequency of GP contact – £127 per hour Basic cost of medication – £170 per year Average cost of a stay in an intensive care unit – £5,169 Average cost of police custody – £363 per night
Enhanced physical well-being	<ul style="list-style-type: none"> Service users report eating well, reducing dependence on alcohol, drugs or smoking and taking more exercise 	<ul style="list-style-type: none"> Average cost of an anti-social behaviour incident – £204 Cost of child support due to parental illness or family stress £45- £56 per week
Service users finding meaningful employment, training or voluntary activity	<ul style="list-style-type: none"> Number for service users finding satisfactory employment, training or voluntary activity Number of service users attaining qualifications, e.g. NVQ2 or higher 	<ul style="list-style-type: none"> Tax and NI paid if in work at minimum wage £1,341 per year Lost economic output whilst economically inactive – £230 per week Incapacity benefit – £750 per claimant per month. Annual benefit to society of voluntary input of 7 hours per week – £1,838
Better and more stable accommodation situation for service users	<ul style="list-style-type: none"> Service users claiming housing benefit without support Decrease in numbers of service users who are homeless 	<ul style="list-style-type: none"> Average cost of each tenancy failure £2,000 Average cost of placement in a Council staffed hostel – £484 per week; local authority group home – £202 Complex need placements – up to £1,200 per week

Sources: Social Exclusion Unit (2004) *Mental Health and Social Exclusion*, Crisis (2006) *Missed Opportunities*, Layard, R (2006) *The Depression Report*.

This table demonstrates the potential costs associated with people suffering from mental health problems to the local and wider public sector. The figures are drawn from the government's own research, from research by the Homeless charity Crisis and from Richard Layard's report on the costs of depression.

Summary

The alternative models presented here offer new ways of conceptualising and measuring efficiency in public services:

- Thinking about the local economic and environmental impacts of public procurement at a defined scale (in the case of local authorities, their local area) provides public sector actors with a more appropriate measure of efficiency when making purchasing and commissioning decisions.
- To ensure social resources are properly incorporated in the efficiency model, public services should be co-produced by commissioners, providers and service users, with the latter seen as assets essential to producing positive outcomes rather than just added expense.
- It is essential to value the social, environmental and economic impacts service providers may bring which are otherwise ignored. Using a *sustainable commissioning* model based on the principles of SROI is a first step in pursuing the longer-term triple

bottom line in public service contracts. This will provide an incentive for providers to maximise positive externalities and social benefit wherever possible, rather than focusing on short-term cost-cutting.

4. Conclusions: rethinking efficiency to redress the balance

In the current market-centred 'narrow efficiency' model, resources are understood solely to be public sector finances or 'the public purse', people and natural resources are neglected. Hence only the 'inputs' that have a financial value are counted. Through this lens, the input/output (efficiency) ratio is most easily enhanced by focusing on price reductions or cost savings.

The perverse result is that outcomes – particularly longer term and those of wider public benefit to people and communities – are not taken into account. The impacts of preventative services, for example, which save money to the public purse but do not put cash in the hand of commissioners, are ignored. Those that are tracked are limited to the service itself rather than wider public benefit, for example, the social, economic and environmental impacts of a service on a community.

Getting truly effective local public services requires government to reverse this perversity; getting *better* and not just cheaper public services means taking a longer-term and more holistic perspective that considers people (beneficiaries, their families, wider community) and the environment as significant as the resources and inputs that can be purchased with taxpayers' money.

Service users also help define desirable outcomes both at the service level and wider level through co-production approaches. The focus is on enhancing outcomes and wider public benefit in *defined local areas* – Michael Lyons's 'place shaping' – rather than maximising short-term financial efficiency (cost savings) at a national level. Desirable outcomes are valued as feeding directly back in to the available resources in a virtuous circle.

A focus on price (or unit costs) will favour larger providers with lower overheads than smaller ones. But this does not necessarily constitute better VFM for a given local area. So, for example, wider public benefit for a community could incorporate having a diverse range of smaller providers, whether they were SMEs or voluntary and community groups.

Gordon Brown has argued that where market failure exists, greater decentralisation of services is required to encourage local innovation. We agree, yet Gershon

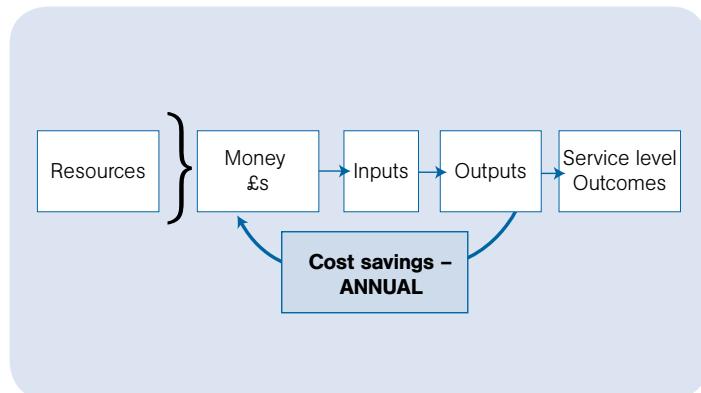
represents one of the most centralising policy tools any government in the UK has ever imposed on local public service actors. Demanding 2.5 per cent efficiency savings per annum drives commissioners to towards short-term cost-cutting behaviour, and these 'savings' disappear into the Treasury's coffers rather than being reinvested at the local level.

A more enlightened system would encourage local authorities to track the results of their services against the wider outcomes they seek for their communities. These wider non-cashable savings could then be credited by central government where the local authority can make a robust case for their achievement, perhaps through greater fiscal or political autonomy. Such a regime would incentivise local innovation but allow for the modest failures that are inherent in any successful system of development and progress. This contrasts sharply with the current approach which constrains innovation in favour of short-term financial savings and long-term decline. In some ways, such a model would be more like real markets, which, as the economist John Kay suggests, are intrinsically *inefficient* – they allow and encourage experimentation and failure as the key mechanism for innovation and change.⁴³

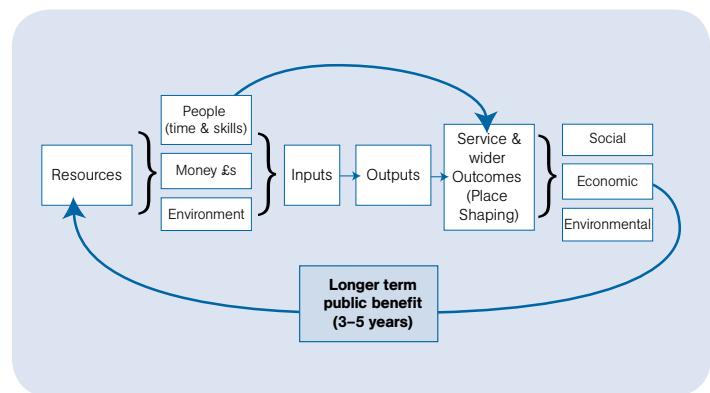
We are a long way from Huxley's *Brave New World* of frightening 'total efficiency'. Yet for some of the most vulnerable members of our society and most disadvantaged communities, there is evidence that the narrow model of efficiency driving decisions about the services they receive is having a damaging impact. The alternative *public benefit* model proposed here offers a new alternative. It offers a way to redress the balance between 'better' and 'cheaper', tempering the market ethos and efficiency drive with a focus on what really matters – that services truly help people and their communities.

As the Treasury sets out its plans for public services for the next four years in the *Comprehensive Spending Review* and builds on the momentum created towards greater local accountability and autonomy, it must adopt a broader model of efficiency, ensuring that efficiency does not eclipse effectiveness. It must put outcomes for people before short-term savings for government.

**Figure 3: Narrow value for money
(input/output focused – short term)**



**Figure 4: 'Real' value for money
(outcome focused – longer term)**



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